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PROTOCOL AMENDING ARTICLE VIII OF THE 1948 TAX CONVENTION WITH RESPECT TO THE NETHERLANDS ANTILLES

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 104–23]

The Committee on Foreign Relations, to which was referred the Protocol Between the Government of the United States of America and the Government of the Kingdom of the Netherlands in Respect of the Netherlands Antilles Amending Article VIII of the 1948 Convention with Respect to Taxes on Income and Certain Other Taxes as Applicable to the Netherlands Antilles, signed at Washington on October 10, 1995, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The current treaty in respect of the Netherlands Antilles generally provides an exemption from U.S. tax for interest from U.S. sources derived by a resident or corporation of the Netherlands Antilles. The purpose of the proposed protocol is to limit the continued applicability of this exemption in order to prevent treaty-shopping abuses pursuant to which residents of third countries inappropriately derive the benefit of the exemption from U.S. tax on U.S.-source interest. The proposed protocol preserves the exemption for interest on certain debt instruments that were issued on or before October 15, 1984, pursuant to financing arrangements that were structured in reliance on the existence of such exemption.

II. BACKGROUND

The Convention between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and

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Certain Other Taxes was signed on April 29, 1948 ("1948 Convention"). The 1948 Convention was extended to the Netherlands Antilles by exchange of notes dated June 24, 1952, August 7, 1952, September 15, 1955, November 4, 1955, and November 10, 1955. The 1948 Convention as applicable to the Netherlands Antilles was amended by protocols signed on June 15, 1955 and October 23, 1963.

On June 29, 1987, the United States gave notice of termination of the 1948 Convention as it applied to the Netherlands Antilles. On July 10, 1987, the United States modified its notice of termination to provide that the termination did not apply to Article VIII (Interest) and certain ancillary provisions of the 1948 Convention. The United States' partial termination of the 1948 Convention as it applies to the Netherlands Antilles was due to concerns about treaty-shopping abuses in connection with the convention.

In 1992, the United States and the Netherlands signed a new Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("1992 Convention"). The 1992 Convention, which entered into force on December 31, 1993, replaced the 1948 Convention. However, pursuant to its terms, the 1992 Convention does not affect the agreement extending the 1948 Convention to the Netherlands Antilles (as modified by the partial termination). The 1992 Convention does not extend to the Netherlands Antilles.

The proposed protocol amending Article VIII of the 1948 Convention in respect of the Netherlands Antilles was signed in Washington on October 10, 1995. The proposed protocol was transmitted to the Senate for advice and consent to its ratification on January 3, 1996 (see Treaty Doc. 104–23). The Committee on Foreign Relations considered the proposed protocol at its Committee business meeting on September 25, 1996.

III. Summary

Article VIII of the 1948 Convention, as extended to the Netherlands Antilles, generally provides for an exemption from U.S. tax for interest (other than mortgage interest) from U.S. sources derived by a resident or corporation of the Netherlands Antilles that is not engaged in a trade or business in the United States through a permanent establishment. The proposed protocol amends Article VIII of the 1948 Convention to limit the exemption from U.S. tax to interest paid on debt instruments issued on or before October 15, 1984 by a U.S. person to certain related controlled foreign corporations.

IV. Entry Into Force

The proposed protocol provides that it will enter into force upon the later of June 30, 1996 or the exchange of instruments of ratification. The proposed protocol further provides that if it has not entered into force prior to January 1, 1997, it will not enter into force.

V. Committee Action

The Committee on Foreign Relations considered the proposed protocol with respect to the Netherlands Antilles on September 25, 1996, and ordered the proposed protocol favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to the ratification of the proposed protocol.

VI. Committee Comments

The Committee on Foreign Relations believes that the proposed protocol with respect to the Netherlands Antilles is in the interest of the United States and urges that the Senate act promptly to give its advice and consent to ratification. The committee has taken note of certain issues with respect to the current treaty and proposed protocol, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters.

The committee continues to believe that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The anti-treaty-shopping provisions of the 1948 Convention as applicable to the Netherlands Antilles are not considered adequate. The United States' partial termination of the 1948 Convention as it applies to the Netherlands Antilles was due to concerns about treaty shopping abuses with respect to the convention. The committee commends Treasury on the proposed protocol which further limits the potential for treaty shopping abuses with respect to the Netherlands Antilles and bolsters the ability to negotiate effective anti-treaty-shopping provisions in treaties with other countries.

VII. Budget Impact

The committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to have a negligible effect on annual Federal budget receipts during the fiscal year 1997–2003 period.

VIII. Explanation of Proposed Protocol

A detailed, article-by-article explanation of the proposed protocol with respect to the Netherlands Antilles is set forth below.

ARTICLE I

Article I of the proposed protocol amends Article VIII of the 1948 Convention to limit the exemption from U.S. tax for U.S. source interest paid to residents of the Netherlands Antilles. Under the amendment, the exemption applies only to interest paid with respect to debt instruments issued on or before October 15, 1984, to a related controlled foreign corporation which was in existence before October 15, 1984, and the principal purpose of which is the issuing of debt obligations or the holding of short-term obligations and the lending of the proceeds of such obligations to affiliates.

According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), U.S. tax principles generally will apply for purposes of determining whether a debt instrument was issued on or before October 15, 1984. In this regard, the Technical Explanation provides that the principles of Rev. Rul. 85–163, 1985–2 C.B. 249, will apply to treat any debt instrument issued after October 15, 1984, pursuant to a binding written agreement entered into on or before such date as having been issued on or before such date, including a debt instrument issued upon the exercise of a warrant or the conversion of a convertible obligation if such warrant or convertible obligation was issued on or before such date. The Technical Explanation further states that the principles of section 957 of the Internal Revenue Code will apply in determining whether a Netherlands Antilles company is a controlled foreign corporation and the principles of Code section 482 will apply in determining whether any person is an affiliate of a controlled foreign corporation.

Some U.S. companies established subsidiaries in the Netherlands Antilles in order to issue debt in the international capital markets. Under this structure, the Netherlands Antilles subsidiary issued so-called Eurobonds in the international market. The Netherlands Antilles subsidiary then loaned the proceeds of these Eurobonds to its U.S. parent or to another U.S. affiliate. The U.S. parent or affiliate thus issued to the Netherlands Antilles subsidiary a debt obligation that corresponded to the Eurobonds issued by the subsidiary. The Netherlands Antilles subsidiary receives interest from the U.S. parent or affiliate on the debt obligation of such parent or affiliate and pays interest on the Eurobonds it issued. The Netherlands Antilles subsidiary relies on Article VIII of the 1948 Convention as extended to the Netherlands Antilles in order to avoid the U.S. 30-percent withholding tax on the interest received from the U.S. parent or affiliate. The interest paid by the Netherlands Antilles subsidiary on the Eurobonds is not subject to any tax by the Netherlands Antilles.

This structure for the international issuance of debt was used by U.S. companies prior to the enactment of the Deficit Reduction Act of 1984 ("1984 Act"). Before its amendment by the 1984 Act, the U.S. 30-percent withholding tax applied to all U.S.-source interest income of nonresident alien individuals and foreign corporations (other than interest on bank deposits and short-term original issue discount). Thus, interest paid to foreign persons on a debt obligation of a U.S. company generally was subject to this 30-percent withholding tax. Although U.S. tax treaties contained provisions that would reduce or eliminate this U.S. withholding tax, the Committee understands that the procedures for claiming the benefits of a tax treaty were too cumbersome for use in connection with a public offering of debt. Accordingly, U.S. companies were effectively precluded from issuing debt directly in the international capital markets.

The 1984 Act provided an exception from the U.S. 30-percent withholding tax for interest on certain portfolio debt obligations that enabled U.S. companies to issue international debt offerings directly. This exception applies to (1) certain obligations issued in bearer form pursuant to procedures designed to ensure that the obligations are held only by non-U.S. persons and (2) certain obligations issued in registered form for which the payor has received a statement that the beneficial owner of the obligation is not a U.S. person. Pursuant to one of several specified limitations, this exception does not apply to interest paid to a controlled foreign corporation by a related person. This exception is effective for interest received after July 18, 1984 (the date of enactment of the 1984 Act) with respect to obligations issued after such date.

In connection with the enactment of this exception, the 1984 Act included a special rule with respect to certain interest paid in connection with back-to-back obligations of the type described above. Under this rule, interest paid on an obligation of a U.S. person to a related controlled foreign corporation is treated for tax purposes as paid to a resident of the country in which the controlled foreign corporation is incorporated. In addition, it was intended under this rule that the corresponding obligation of the controlled foreign corporation be recognized as an obligation of the controlled foreign corporation. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS–41–84), December 31, 1984, p. 397. This special rule applies only to interest paid on obligations issued before June 22, 1984 (the date of conference action on the 1984 Act) to a controlled foreign corporation that was in existence on or before such date. In order to be eligible for this special rule, the controlled foreign corporation must satisfy certain other requirements, including a requirement that the principal purpose of the controlled foreign corporation be the issuance or holding of debt obligations and the lending of the proceeds thereof to affiliates and a requirement that the debt-equity ratio of the controlled foreign corporation be not more than a specified ratio.

On October 15, 1984, the Internal Revenue Service published Rev. Rul. 84–153, 1984–2 C.B. 383, which specifically addresses the applicability of the exemption under Article VIII of the 1948 Convention in the case of this type of back-to-back financing arrangement. The ruling provides that a Netherlands Antilles subsidiary that participates in this type of arrangement and that is not eligible for the special rule provided in the 1984 Act is considered a mere conduit; as such, the interest payments to such subsidiary are not eligible for the exemption from U.S. tax under Article VIII of the 1948 Convention.

The requirements for continued exemption under the proposed protocol basically mirror the requirements of the special rule provided in the 1984 Act. However, the proposed protocol reflects the October 15, 1984, date on which the IRS revenue ruling was published rather than the June 22, 1984, date of the 1984 Act rule. The Technical Explanation states that application of the continued exemption to debt instruments issued on or before October 15, 1984, reflects the Internal Revenue Service practice of extending the 1984 Act rule to debt instruments issued on or before the date the revenue ruling was published. The Technical Explanation further notes that although the proposed protocol does not explicitly condition the continued exemption on satisfaction of all of the requirements specified in the 1984 Act rule, failure to satisfy such requirements (e.g., failure to meet the specified debt-equity ratio requirement) generally will result in the controlled foreign corporation being treated as a mere conduit that is not eligible for the benefits of Article VIII of the 1948 Convention.

ARTICLE II

Article II of the proposed protocol provides that the proposed protocol is subject to ratification in accordance with the applicable procedures of the United States and the Netherlands. The proposed protocol provides that it will enter into force upon the later of June 30, 1996, or the exchange of instruments of ratification. The proposed protocol further provides that it will not enter into force at all if it has not entered into force prior to January 1, 1997.

IX. Text of Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Protocol Between the Government of the United States of America and the Government of the Kingdom of the Netherlands in Respect of the Netherlands Antilles Amending Article VIII of the 1948 Convention with Respect to Taxes on Income and Certain Other Taxes as Applicable to the Netherlands Antilles, signed at Washington on October 10, 1995 (Treaty Doc. 104–23).

APPENDIX

WRITTEN STATEMENT OF JOSEPH H. GUTTENTAG, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY BEFORE THE COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE, SEPTEMBER 24, 1996

Mr. Chairman and Members of the Committee: I am pleased to submit this statement on behalf of the Administration to recommend favorable action on the protocols to two tax treaties, with Indonesia and with the Netherlands with respect to the Netherlands Antilles, that are on the Committee's business meeting agenda. Also on the agenda is the tax treaty with Kazakhstan, on which the Administration recommended favorable action in testimony before the Committee on June 13, 1995. There are also three additional bilateral tax treaties that the President has transmitted to the Senate, with Austria, Luxembourg, and Turkey. All these agreements provide significant benefits to the United States, as well as to our treaty partners. Treasury appreciates the Committee's interest in these agreements, and requests the Committee and the Senate to take favorable action at this time on the three agreements that are on the Committee's agenda, and on the remaining three treaties as soon as possible.

The tax treaty program is designed to remove obstacles to international trade and investment, such as double taxation, and to prevent fiscal evasion, such as through treaty shopping and information concealing. Accordingly, tax treaties provide substantial benefits to taxpayers as well as to the fiscs of both treaty partners.

For example, high withholding taxes at source are an impediment to international economic activity. Under United States domestic law, all payments to non-United States persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Inasmuch as this tax is imposed on a gross rather than net amount, it imposes a high cost on investors receiving such payments. Indeed, in many cases the cost of such taxes can be prohibitive. Most of our trading partners impose similar levels of withholding tax on these types of income.

Tax treaties alleviate this burden by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, United States policy is to reduce the rate of withholding taxation on interest and royalties to zero. Dividends normally are subject to tax at one of two rates, 15 percent on portfolio investors and 5 percent on direct corporate investors, with certain exceptions.

The Treasury Department has included in all its recent tax treaties comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to bona fide residents of the treaty partner. These provisions are not uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, these provisions should be crafted to avoid interfering with legitimate and desirable economic activity. For example, in the future we plan to address directly in our negotiations the issue of how open-end United States regulated investment companies (RICs) should be treated under limitation on benefits provisions in order to facilitate cross-border investments from this important source of capital. Because these funds are required to stand ready to redeem their shares on a daily basis, we believe they generally should be entitled to treaty benefits to the same extent as closed-end RICs, which qualify for benefits, under standard limitation on benefits provisions because they are publicly traded on stock exchanges. However, the extent to which this goal may be achieved is likely to vary from treaty to treaty, as the negotiators need to ensure that mutual funds established in the treaty partner cannot be used to promote treaty shopping.

Our tax treaties and treaty positions are subject to continual review. We reexamine the appropriateness and effectiveness of our treaty provisions, and receive comments from both public and private sources. The release last week of the new U.S. model income tax treaty, copies of which were provided to the Committee, is an important step in this process but does not represent its conclusion. The new model represents our favored treaty positions at this time; we will reevaluate and update the model over time as we evaluate model treaty positions as employed in our recent tax treaties and receive comments and further suggestions on the model itself.

DISCUSSION OF PENDING AGREEMENTS—INDONESIA, NETHERLANDS ANTILLES, AND KAZAKHSTAN

I would like to discuss the importance and purposes of each agreement that the Committee has set for consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement. We have furnished our treaty partners with a copy of the relevant technical explanation and offered them the opportunity to submit their comments, suggestions and concurrence.

Indonesia

The proposed protocol with Indonesia, which was signed at Jakarta on July 24, 1996, amends the income tax treaty with Indonesia that was signed in 1988 and entered into force on December 30, 1990. In many cases, the withholding tax rates permitted under the existing tax treaty with Indonesia significantly exceed those found in Indonesia's treaties with other OECD countries. This places United States business at a substantial competitive disadvantage in Indonesia relative to competitors from other industrialized countries. Because Indonesia is one of the world's most populous countries, with a rapidly expanding market that is located in a region of dynamic economic growth, it is especially important that United States firms be able to compete there without this disadvantage.

The proposed protocol achieves this objective by reducing the withholding tax rates permitted to bring them into line with those in Indonesia's recent treaties with other OECD countries. The protocol reduces the maximum rates of tax on direct-investment dividends, interest, and royalty income, which are generally 15 percent under the current treaty, to 10 percent.

Netherlands Antilles

Many years ago, the United States and the Netherlands agreed to extend the then treaty between them to the Netherlands Antilles. The extension became a contentious issue, and in 1987 most of the provisions of the treaty as extended to the Netherlands Antilles were terminated, except for the taxation of interest at source and ancillary provisions. The proposed protocol to the Netherlands treaty relates only to the Netherlands Antilles and would complete the termination by eliminating the exemption from United States withholding tax for interest, except with respect to certain grandfathered debt instruments.

The proposed protocol relating to the Netherlands Antilles would eliminate ongoing treaty shopping through the Netherlands Antilles by limiting the exemption from United States withholding tax to certain debt instruments issued on or before October 15, 1984. These debt instruments were issued in connection with Eurobond offerings by Netherlands Antilles subsidiaries of United States companies, generally before the Deficit Reduction Act of 1984 allowed United States companies to issue debt, free of United States withholding tax, directly into the international capital markets. It is appropriate to provide a continued exemption for these debt instruments because the Eurobonds were issued in reasonable reliance on the continued existence of the exemption and it is believed that eliminating the exemption entirely would have an adverse effect on international capital markets.

Kazakhstan

In addition to the five new treaties and protocols, the Committee still has under consideration a treaty between the United States and Kazakhstan. This treaty was the subject of a hearing last year. At our request, the Committee delayed its vote on this treaty until we received adequate assurances from the Government of Kazakhstan regarding access to bank account information. At the time of last year's hearing, Kazakhstan had recently adopted laws permitting the opening of anonymous bank accounts, and we wanted to be certain that the existence of these accounts would not, as a legal or a practical matter, impede our access to bank account information in order to enforce our tax laws.

I am pleased to report that Kazakhstan is now clearly moving away from bank secrecy. The Government of Kazakhstan has submitted legislation to the Kazakhstan Parliament to repeal the earlier laws permitting the establishment of anonymous bank accounts. We understand that the lower house of the Kazakhstan Parliament has passed the legislation and that the Government of Kazakhstan expects the law to be enacted without opposition this week.

We appreciate the Committee's support on this very important issue and hope that we can work cooperatively to move this treaty forward while at the same time protecting the integrity of the treaty's exchange of information provisions. One alternative that we would support is for the Committee to report the treaty recommending that the Senate give its advice and consent to ratification assuming Kazakhstan's adoption of the new law. The full Senate then could approve the recommendation with appropriate conditions concerning the elimination of anonymous bank accounts. We have provided the Committee with the latest information we have regarding the status of this issue and will continue to keep the Committee advised. If the Senate chooses to give its advice and consent to the treaty at the present time, the Administration is willing and able to accept the responsibility of not permitting instruments of ratification to be exchanged until it is fully satisfied that the conditions described above have been fully satisfied. Absent this procedure, entry into force of the treaty could be further substantially delayed. Based on information we have received it would be in the interest of the United States to have the treaty enter into force as promptly as possible.

We will continue to work with the Committee and its staff to bring this issue to a mutually satisfactory conclusion.

CONCLUSION

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program. We appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process. With your and their help, we have over the past several years brought into force 19 new treaties and protocols.

We urge the Committee to take prompt and favorable action on the three agreements before you at the business meeting. We further urge the Committee to take favorable action as soon as possible on the remaining three tax treaties that the President has submitted to the Senate. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the United States treaty network with income tax treaties formulated to enhance the worldwide competitiveness of United States companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. Finally, it will make clear our intention to deal bilaterally in a forceful and realistic way with treaty abuse.